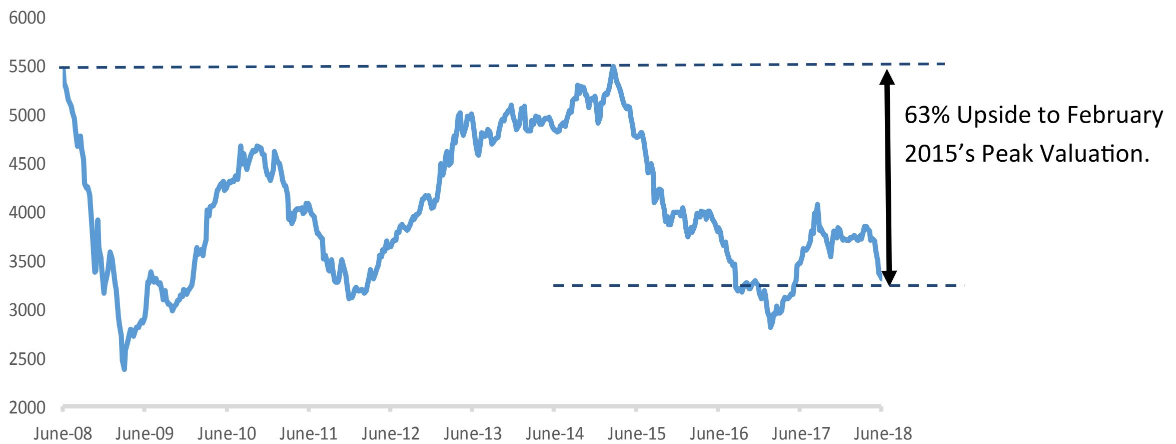
Equities

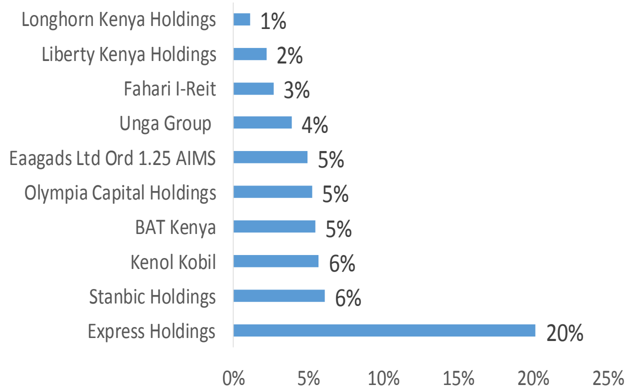
We note that April's market inactivity carried over into May with the NSE-20 index falling further (-10.8% to 3333.36 points as of 30th May). We especially highlight that some of the key counters that were driving the rally in the first quarter seemed to have lost steam as investors who heavily profited in the first quarter exited. For example, counters such as Equity Group gained 33% which prompted profit taking from foreign investors especially. We also make note of the fact that investor appetite also dwindled in April and May after many of the shares traded ex-dividend. For Safaricom, we believe that concerns over the company's overvaluation (i.e. the stock hit an all-time high of KES 33.50 which was unsupported by fundamentals) convinced investors to pull back and take some gains off the table. From a technical standpoint, we flag that the market is trading at a 63% discount to its 10-year peak price (c. 5400 points) thus implying further scope for growth. We hold that any amendments to the interest capping law as well as increased investor interest in Safaricom is likely to make the recover from the price declines that we saw in April and May.



Source: Bloomberg

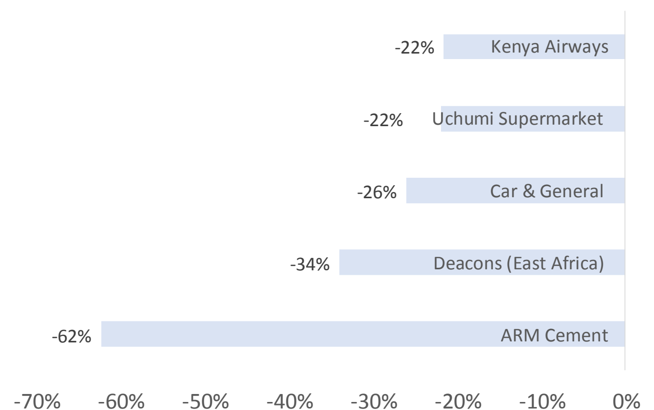
As an illustration of how slow the activity in the month was, none of the 10 largest stocks by market capitalization made it onto the top gainers or decliners list-which is a departure from the trend that had built up so far this year. Unsurprisingly, Express Holdings led the top gainers following a takeover offer by one of its anchor shareholders. Similarly, an intention by Stanbic Africa Holdings to further consolidate their shareholding in the Stanbic Holdilngs prompted investors to purchase the stock. We believe that the other stocks were driven by individual retail demand rather than broad-based institutional investor interest. For ARM Cement, we believe that reports of the company's deteriorating financial health and governance challenges precipitated a collapse in the share price. We believe the declines in the shares of the other counters could have been explained by the poor financial performances of the counters over the last few years.

Top gainers in May



Source: NSE and NIC Securities Research

Top decliners in May



Source: NSE and NIC Securities Research

Catalysts and Risks Going Forward.

Banks' Q2 results and amendments to the rate cap law: We expect solid Q2 performance driven by cost-efficiencies, efforts to contain interest expenses and growing non-funded income. We do believe that a key risk to the earnings is an elevation in loan loss provisions in the second quarter which could unwind the strong profit growth seen in the first quarter. We also hold that any amendments to the interest rate capping law could revive private sector credit growth that has been crippled over the last 2 years or so thus driving stronger profit growth going forward.

Macroeconomic indicators

- **Foreign Exchange:** The currency weakened (-1.3% to USD/KES 101.60) over the course of May due to what we believe were strong demand from multinationals and importers thus slightly reversing the appreciation trend that was witnessed between January and April (+2.9%). We believe, though, that the currency is likely to play within the USD 102-103 band for the remainder of the year on strong importer demand and rising oil prices which are expected to further upward pressure on the current account deficit and thus erode the shilling's strength that was witnessed in the first four months of the year.

- **Inflation:** In the first half of last year, there was widespread concern about the likely trajectory of food inflation owing to the fact that the significant expansion of food inflation (Jan'17-May'17: +898 bps to 21.52%) during that interval had shown little signs of slowing. The hope of a turnaround in the inflation story was hinged on the long rains (expected to fall between March-May) which were expected to ease drought that was being experienced at the time and hence put downward pressure on both the food and headline inflation. Since June, a material difference has been witnessed with the food inflation falling (from 15.81% in June) to 54.5% in December. However, we note that in the first four months (Jan: 4.83% , Feb: 4.46% , Mar: 4.18% and Apr: 3.73%), headline inflation seemed to be contained owing to the high food inflation rates experienced at the beginning of last year. Last month, however, inflation rose to 3.95% on a sudden rise in food items such as tomatoes (+15% y/y) and spinach (+5% y/y). In aggregate, we expect the inflation rate to peak at 7% this year owing to favorable weather that is expected to put downward pressure on food prices.
- **Fixed Income and Treasury Bills:** Last month, we note that the T-bill auctions yielded healthy subscriptions (167.5% in May). The oversubscription could be attributed to low yields offered on the 15-year bond's yield which was much lower than investors would have liked. We note that the government has reached its borrowing target for the financial year and is thus we expect that the CBK will have more leverage than the market and thus would likely be less willing to accept more expensive bids from institutional investors thus implying a stabilization of yields this month.

STOCK PICKS

Bamburi Cement: BUY at TP of KES 242, Current Price KES 177.00

- Bamburi Cement has reported a 50% decline in FY17A PBT to KES 4.1bn, a poor performance but in line with the 37% decline in 1H17 PBT. Revenue performance was as bad, posting a more benign decline of 6% to KES 35.9bn, weighed down by an election affected performance in BMBC's main market of Kenya. But costs were the biggest challenge with EBIT down 47% as commodity and electricity prices rose. DPS declined significantly by 66% to KES 4.00 from KES 21.00 in spite of the payout ratio increasing to 88% from 83% in FY16A.
- Provisional data from KNBS show that cement consumption in Kenya contracted by 8% in 2017 to 5.8mtpa. This pales in comparison to the 11% growth reported in 2016. As discussed in our sector update note last year, access to credit continued to be a major inhibitor to the construction sector as Kenya's private sector credit growth decelerated to low single digits in 2017. Management blamed higher energy costs with electricity and coal prices rising. The former was due to Kenya switching to the more expensive thermal energy as HEP production was impaired by drought. The latter follows global commodity prices spike. 1.8mtpa of new capacity is on course to be added in 2H18 at both Nairobi Grinding Plant (NGP) and Tororo. Rebound in private credit sector growth is crucial especially in driving individual home builder consumption, which accounts for 75%-85% of total cement consumed in the region. Resumption of infrastructure will have a direct effect on construction rebound in 2018.
- We anticipate easement of electricity prices in Kenya in 2018 following increased HEP generation due to long rains. With thermal generation costing as much as USc.22/KWh compared to HEP's USc.3/KWh, the savings y/y should be significant as the country switches back to HEP. While exciting, the introduction of off-peak electricity prices, meant to incentivize companies to increase production, will unfortunately not benefit BMBC and ARMC as they are already operating near full capacity utilization levels. We expect cement prices to edge upwards as production costs rise and industry capacity utilization increases. We expect BMBC's EBIT margin to recover (FY18F; 20%, FY17A; 21%) ALSO ON THE ASSUMPTION THAT SALES WILL GROW AT c.15% boosted by the new capacity in 2H and relatively better cement prices.

Centum (Unrated). Current Price: KES 39.00.

- **PBT falls by 21% on underperformance of financial services subsidiaries:** Centum Group posted a drop in its half-year PBT (-21% y/y to KES 2.2bn) largely driven by a material contraction (-35% y/y to KES 1.6bn) in income from financial services. Management attributes the dip in income to reduced fee management income and interest income witnessed in its asset management (GenAfrica and Nabo) and banking (Sidian) subsidiaries respectively. The financial services division subsequently realized a loss (KES 111.5m) thus reversing last year's profit (KES 571.3m). The company's trading business, however, was immune to the tough operating environment (between March and September) with a solid (+9.4% y/y) jump in trading profit (to KES 548.9m) being the evidence of the division's resilience. We also note than investment and other income also grew (+15.4% y/y to KES 2.2bn) which we attribute to unrealized and realised gains made in its real estate portfolio.

- **Beverages business underpins solid trading profit growth:** We note that the trading business (beverages, agribusiness, utilities and publishing) posted a stronger growth in sales (+15.8% y/y to KES 4.8bn) owing to improved performance (+8% y/y to KES 4.0bn) in the beverages business (c.86% of trading sales). The publishing business (c.11% of trading sales) also performed materially better (+41%) on a year-on-year basis. Direct and other operating costs, however, increased materially (+16.7% y/y to KES 4.2bn) predominantly driven by the beverage business.

- **Focus turns to turning around financial laggards:** As has been mentioned in the first paragraph, we note that the financial services division reversed its profit in 1H17 to post an operating loss in 1H18. Nevertheless, the group is keen on turning around the division's performance with plans afoot to improve Sidian's contribution of non-funded income to the total income (c.20% as of 1H17) of the bank (to 50% by FY18) for instance. We also believe that efforts to improve its sour loan book (NPL Ratio: c.18% as of 1H18) are underway in order to usher the bank back into profitability. We believe that the asset management divisions' turnaround is based on a resumption in risk appetite in the financial markets as a whole which the business expects to happen from the beginning of CY18.

- **Strategy ticks all the boxes; execution is key:** We are quite constructive on the group's outlook. Our view is informed by their focus on squeezing more profits from the trading business (through revenue acceleration and cost containment) and aggressively rolling out plans to execute their rich project pipeline (real estate, education and health sector projects in particular). Moreover, we like their efforts to delever (Debt-to-Equity Ratio: FY17: 33% vs. 1H18: 28%) by retiring their Equity-Linked Bond (KES 4.3bn). However, we believe that execution of the projects is likely to be key risk to the group's rosy outlook. We note that failure, for instance, to aggressively sell construction ready sites as well as quickly turning around the financial services subsidiaries would taint (at least temporarily) the solid business momentum that the group has had for the last 6 years (c.26% CAGR growth in NAV). That said, we note that the company's stock is trading (KES 46.00) at a lower point than the latest NAV (KES 62.50) would suggest therefore implying that now would be a good time for investors to buy.

CIC Insurance Group (Not rated): Current Price KES 4.55

- CIC Insurance Group posted a 354% rise in PBT (FY17A: KES 519.2m vs. FY16A: KES 114.4m) driven by robust growth in the gross written premium (+21% to KES 14.95bn) and investment income (+18.6% to KES 1.54bn). Understandably, there was a corresponding increase in the net earned premiums (+20.6% to KES 12.1bn). We also note that the loss on monetary position associated with the South Sudan reduced on a year-on-year basis (-55% to KES 233.9m) which helped to boost the bottom-line. The group announced an increase in the dividend (FY17A: KES 0.120 vs. KES 0.105).

- We highlight that the increase in investment income (+18.6% to KES 1.54bn) was driven by increased allocation of the firm's assets towards government securities (+38.6% to KES 6.4bn) and deposits with financial institutions (+28% to KES 4.8bn). These two assets account for nearly two-fifths of the company's assets (c.37%) as of December 2017. We believe that the consistent income streams that these securities provide make them an attractive feature from an investment perspective. Equity investments presumably grew (+38.5% to KES 1.3bn) due to what we believe was a good year for the stock index as the NASI strongly grew (+28%). Investment properties grew modestly though (+10.5% to KES 6.4bn).

- We understand that management is keen on implementing its 2017-2021 strategic plan that is aimed at aggressively growing its market share in the life and non-life insurance segments in order to be the market leader. We believe that the robust growth in the gross written premiums is a testament to the company's ability to capture aggressively capture new business. Despite the company's sound strategic initiatives, we believe that the company's valuation is elevated (Trailing P/E ratio; 25.3x) and we would caution against aggressive accumulation of shares. We would advise clients to enter once we see some downside in the stock. Levels of KES 3-4 are good entry points.

Safaricom. HOLD at TP: KES 31.31; Current Price: KES 28.50.

- **Safaricom reported a FY18 EPS growth of 14% to KES 1.38 (NICS estimate of KES 1.34), marking its slowest growth in earnings over the last 5 years.** A lower depreciation charge of 14%, compared to an average charge of 16% in the preceding 3 years, embellished the performance, otherwise, growth would have been 8%. MPESA and mobile data decelerated further than anticipated, growing at 14% and 24% versus our estimates of 17% and 30% respectively. DPS increased by 13% to KES 1.10.

- **MPESA revenues (28% of service revenues) decelerated from 33% y/y to 14%, the first deceleration in four years (FY14A).** While management blamed the difficult macroeconomic environment for the slower growth, which can be corroborated by the slower growth particularly in 'new business' (C2B, B2C, B2B) at +24% (FY17A; +103%) competition was also a factor. As alluded to in our 1H18 note, management reduced 'bank to MPESA' transfer charges by c.33%, while person to person (P2P) transfers charges declined by 27% in response to increased competition from largely Equitel. Additional cuts were effected on Lipa Na MPESA (LNM) tariffs by 50% in the same period. Average transactions per user per month increased by 14.6% to 11, slower than the 35% growth recorded in the preceding period.

- **Mobile data (16% of service revenues) continued to decelerate, growing by 24% versus the 38% growth reported in the corresponding period last year**. This continues the deceleration recorded in the three preceding financial years (FY15A; +59%, FY16A; +43%, FY17A; +38%). Usage per user continues to rise (FY18A; +56% to 421MBs, FY15A; +38%, FY16A; +77%, FY17A; +52%) implying either a slower accretion in subscriber numbers and/or lower data charges. Absolute Data subscriber net-adds declined for the for the first time in 3 years with 1.03m added compared to the 2.56m added in FY17A. Data prices, which declined by 29% y/y as at 1H18 (1H17; 16%) have been under pressure from increased competition with Airtel and Telkom Kenya significantly cheaper (refer to 1H18 results note for price comparisons). For instance, KES 1,000 will buy 6GB on Airtel, 4GB on Telkom and 3GB on Safaricom. Voice revenues (43% of service revenues) grew at a flat rate of 2%, despite Safaricom's subscriber market share declining by 280bps q/q to 69.1% as at December 2017, according to the CA's quarterly sector statistics. Airtel Kenya was the biggest beneficiary gaining 230bps q/q to 17.2%. This coincides with the main political opposition party NASA's boycott call of Safaricom products in the aftermath of the October 26th General Elections. Net adds were only 1.4m, 50% lower y/y and despite this, monthly voice ARPU contracted by 7% to KES 272, suggesting reduced usage. This is confirmed by our MoU estimate of 92, 5% lower y/y.

- **Maintain HOLD at TP of KES 31.31 (Previously HOLD at KES 25.85) We adjust our EPS forecasts marginally (FY19F; +2% and FY20F; +0.6%) to KES 1.50 and KES 1.57 respectively.** We maintain our view of a deceleration in the main revenue drivers MPESA and Mobile data in the near term under increased competition. While the boycott call has been lifted, we are unlikely to see the subscribers who exited troop back, on realization of how relatively affordable Airtel Kenya is and given that their offering is almost on par. In fact, we expect a slower accretion in subscribers for Safaricom going forward. Elsewhere, we see little impact of mobile money interoperability, which allows the seamless transfer of money across different networks. Already, telcos are insisting that withdrawals can only be done with their agents. We maintain that the only way to compete with MPESA is to become as ubiquitous. We assign a higher relative valuation weighting in deriving our blended TP (70% from 60% before) given the counter's increasingly lofty valuation. HOLD.

BRITAM (Not rated): Current Price KES 13.00

- Britam posted a 73% dip in full year profits (to KES 527.5m) driven by a steep increase in the provision for a change in actuarial value of policyholder benefits. We understand that there was a reversal of the gain in 2016 as a result of changes in the industry's way of changing the way insurance liabilities are to be valued.
- FY17 gross earned premiums grew at a higher pace (+14.8% to KES 23.3bn) than net earned premiums (+16.7% to KES 20.3bn). Fund management fees, however, declined (-18.1% to KES 760.6m).
- The group's asset base rose (+18% to KES 99.0bn) as of December 2017. Specifically, financial assets at fair value through profit or loss solidly rose (+66.4% to KES 30.6bn).
- Going forward, we expect maritime insurance to drive further growth for the industry following recent regulatory changes that requires commercial importers to take insurance exclusively with local underwriters. We believe that Britam, being a market leader with a reputable brand and significant financial capacity, will be a key beneficiary. The insurer launched a self-service online portal late last year in a bid to tap into the KES 23bn marine business.
- We also believe that the counter warrants investor confidence considering that two institutional investors (IFC and AfricInvest) have pumped in (or are planning to pump in) in KES 9.25bn in the company to acquire 10.37% and 14.3% stakes respectively.
- Currently Britam trades at a trailing P/E of c.50.0x which is significantly above the c.10x average over the course of last year. We believe that a resumption in profitability is likely to enable the company to trade at a more favorable valuation.

Kenya Re (Not rated): Current Price KES 17.10

- FY17 PAT increased by 8.8% to KES 3.5bn. In the period under review, the grew by 7% boosted by a 8% growth in net earned premium to KES 13.7bn.
- The firm's earnings from investments rose (+3% to hit KES 3.16 billion) this year compared to KES 3 billion in the previous period.
- Net claims incurred also grew (+14% to KES 7.59 billion) on the back of the earthquake related compensation pay-outs in Nepal and floods experienced in India, said the re-insurer .
- Total outgo was outpaced by total income, growing at 8% to KES 6.5bn. This was due to a marginal increase in net claims and policyholder benefits of 2% to KES 3.6bn.
- Kenya Re opened its Zambia regional office in November 2016, in line with its regional expansion strategy as it seeks to increase reinsurance capacity for insurance companies in Africa. The regional office is expected to serve Namibia, Zambia, Zimbabwe, Botswana, Mozambique, Lesotho, Swaziland Malawi and Angola. while boosting good risk management and innovative insurance practices in the region. The reinsurer expects to benefit from the new Zambian government trade strategy for local and international investment as the country tries to diversify away from copper mining.
- With mandatory cessations by insurers to Kenya-Re still in effect till 2020, we anticipate the reinsurer to reap from underwriting maritime insurers. Experts anticipate local insurers will increase their reinsurance cover in order to increase their capacity to underwrite large shipments.
- Currently KNRE trades at a P/E 3.6x which is attractive relative to Britam and CIC Insurance.

EABL BUY at TP of KES 328; Current Price KES 232.00

EABL this morning held an investor briefing to release its 1H18 results. The performance was below our expectations with the EPS declining by 17% to KES 5.21. Net sales were flat, weighed down by a poor performance in main market Kenya.

- Kenya reported a 4% decline in net sales, weighed down by a 22% dip in Senator sales. This was occasioned by an increase in tax on Senator as the duty remission was reduced to 80% from 90% in April 2017. Consumption of the value brand was also affected by the protracted electioneering period and drought earlier in the year, resulting in reduced disposable incomes. EABL management additionally attributed the poor Senator Keg performance to a temporary shut down of the plant in order to effect a capacity upgrade. Elsewhere, mainstream and premium beer products re-ported growths as the effects of the punitive 2015 excise tax continue to gradually wear off. Interestingly, reserve and imported spirit brands recorded a significant de-cline of 21%. Kenya's performance with Senator excluded was an NSV growth of 5%.

- While Kenya underperformed, Tanzania was a star performer as its revenues re-bounded to grow at 28%, a turnaround from the 12% decline reported as at FY17A. This was attributed to innovation, price mix and the sponsorship of the Tanzania soccer team. On innovation, the introduction of Serengeti Lite proved hugely successful, according to management while the Soccer team's sponsorship resonated well with the population. Uganda, EABL's second largest market reported a 4% growth in NSV. .

- Work on the Kisumu brewery commenced in June 2017 and is set for completion in July 2019. The Senator Keg plant will cost KES 15bn, of which KES 12.5bn will be debt and the remainder from internally generated cash. Already KES 2bn has been spent on the project since breaking ground. In 1H18, EABL also spent KES 800m on Spirit line and KES 900m on a short term Senator Keg investment where they purchased kegs and rackers.

- Net borrowings increased by 4% to KES 25.9bn owing to the increased capital investments. There was a notable increase in interest expenses as EABL restructured some of its short term debt to long term.

KENOL KOBIL (Not rated): Current Price KES 17.20

- Kenol Kobil has reported a slight gain in both FY17A PBT and PAT of 4.02% and 2.13% respectively. This is a fairly good earnings performance (y/y growth) in the sector, despite incurring a dispute settlement cost of KES 570m and a surge of 57% of COGS against a net sales growth of 53%. A total dividend of KES 0.6 will be paid out in 2017 of which KES 0.3 was interim, recording a growth of 33.3% y/y. The gross profit markedly grew by 7.2% y/y to KES 7.9bn and has consistently been on an upward trend from a low of KES 5.1bn in 2014. The revenue growth has also been increasing fueled by increased international oil prices and Open Tender System (OTS) trading volume resulting from strategic relationships with oil producers.

- The financing costs retreated by 4% to KES 340m from KES 354m. This was as a result of stringent inventory and cash management strategies. The strategies include restructuring of bank facilities of which cash generated was significantly utilized in debt reduction. However, the financing income grew by 109% but the net financing costs slumped by 44%.

- Administrative and operating costs went up by 24% to KES 3bn from KES 2.5bn. This was driven by ESOP payment to former CEO which is a one off payment, and expansion of business levels. Forex loss was quite high at KES 47m which is twenty fold from a gain of 2.5m in 2016. The current ratio improved from 1.26 in 2016 to 1.44 y/y, while the gearing ratio grew by 400bps y/y to 30% as at end of 2017. Shareholders funds increased from 9.9bn in 2016 to 11.2bn in 2017 which is a 13% growth.

- The group is confident that the growing performance has been triggered by cost containment, efficiency allocation of resources, strategic partnership, network expansion and venturing into unexploited lines. The group carries no long term debt after having fully provided for 1.8bn KPRL yield shift receivable in 2017 (KES 570m last installment), while short term debt is fully being channeled to trade financing. With the absence of extraordinary operating expenses like ESOP settlement which was a one off payment in 2017 and provision for impairments, FY2018 is expected to have a much higher growth in profits, dividends and capital gain.

Co-op Bank Group: HOLD at TP of KES 18.05, Current Price KES 16.50

COOP Bank has reported a 7% and 10% decline in FY17A PBT and PAT to KES 16.4bn and KES 11.4bn respectively. The results are in line with the 9M17 PBT decline of 10% and highlights COOP Bank's struggles in adapting to the rate caps as illustrated by the 5% decline in NII. As earlier indicated, with the exception of KCB, few banks will have succeeded in growing NII in FY17A. An additional concern was the near doubling in NPLs that pushed the NPL ratio to 7% (+3.7ppts). The DPS was kept flat at KES 0.80.

weak margin management hampers earnings: As intimated in our sector update note 'UP AGAINST IT' dated 10th October 2017, the banks that took on more risk got more reward. This was in the context of KCB's and COOP's decision to continue lending unlike EQB who preferred to lend to the government. In the analysis, we were able to show that because customer lending is a significantly larger chunk of assets, not lending led to a significant drop in interest income on loans and in turn, a more significant decline in NII relative to banks that lent. A distinction between KCB and COOP was that the more aggressive lender reported a lower decline in interest income on L&A, supporting the thesis that volumes could in fact offset the lower yields. This can be proven from the 1H17, 9M17 and FY17A results with KCB's loan growth in these periods outpacing COOP's and in turn reporting a lower decline in Interest income throughout. COOP's loans grew at 7% with II declining by 4.3%. COOP also proved adroit at managing funding costs with interest costs dipping by 7% despite a 10% increase in customer deposits however this was not enough as NII declined.

Asset quality deteriorates significantly: The increased lending would appear to have come at a price with COOP's previous best industry asset quality deteriorating by 3.7ppts y/y to 7%. Gross NPLs increased by 66% in the period, with the real estate and trade sec-tors culpable. Interestingly, interest in suspense in that period declined by 16%. The Cost of Risk increased by 30bps to 1.4%, after a 38% increase in the loan impairment charge.

A more lenient implementation of IFRS 9 on the cards?: Lack of a definitive word on the implementation of IFRS 9, set to commence in 2018 has brought about confusion. The CBK, in a letter to the banks dated 23rd December 2017, drafted a proposal that while the P&L would carry impairment charges as determined by IFRS 9's Expected credit loss (ECL) model, for purposes of 'protecting' an industry already afflicted by interest rate caps, the incremental difference (between IFRS 39 and IFRS 9) would be added back to retained earnings to spare the banks from the expected hit on capital for a period of five years. This was a proposal with the banks expected to provide feedback. As to the differences in implementation, It should be noted that Barclays bank Kenya and StanChart Bank Kenya got rid of their statutory loan loss reserves in the course of 2017 in readiness for IFRS 9, albeit by crediting instead of debiting their retained earnings

We maintain SELL at TP of KES 18.05 (Previous TP of KES 16.76)

The recent speculation on a possible repeal/amendment to the rate cap law has seen banking counters rally with COOP gaining 20% YTD. At this point it is just speculation with no decisive steps taken or discussed. Our model assumes status quo therefore. Additional-ly, we continue to assume the implementation of IFRS to the letter until otherwise declared. COOP has guided at a CoR of 1.6% for FY18F, a 10bps y/y increase. COOP's loan loss reserves are relatively low at KES 718m versus KCB's 11bn while the chasm between the IFRS and CBK coverage ratios is 18ppt wide compared to KCB's 26ppt. COOP's RoAE declined by 520bps y/y to 17.5%. We maintain our FY18F RoAE forecast of 19.5% versus management's guidance of 20-22%. COOP's trailing PB of 1.4x is slightly more pricey than our excess equity method derived 1.2x.

KCB Group: SELL at TP of KES 33.97, Current Price KES 46.25

KCB has reported a flat performance in both FY17A PBT and PAT at KES 29.1bn and KES 19.7bn respectively. This is likely to be the best FY earnings performance (y/y growth) in the sector, judging by how the banks had performed as at 9M17. KCB had then posted a 3.1% growth in PBT (boosted by a restatement of 9M16 numbers, otherwise PBT would have been down by 2.3%) while EQB and COOP reported 4% and 10% declines respectively. A spike in employee costs due to severance pay and a 50bps q/q increase in cost of risk slowed down the earnings momentum in Q4. DPS was kept flat at KES 3.00.

Strong margin management underpins earnings: As intimated in our sector update note 'UP AGAINST IT' dated 10th October 2017, the banks that took on more risk got more reward. This was in the context of KCB's and COOP's decision to continue lending unlike EQB who preferred to lend to the government. In the analysis, we were able to show that because customer lending is a significantly larger chunk of assets, not lending led to a significant drop in interest income on loans and in turn, a more significant decline in NII relative to banks that lent. KCB's FY17A loans grew at 10%, a deceleration from the 15% growth reported as at 9M17A. KCB had also proved adroit at managing funding costs then and continued in the same vein with funding costs declining by 6% despite an 11.5% growth in customer deposits. NII increased by 3%, a feat few banks will manage in their FY17 results.

Asset quality pays the price: The increased lending came at a price as the NPL ratio and the cost of risk both increased by 50bps y/y to 8.5% and 1.5% respectively. The SME and Micro book were the largest culprits recording a 330bps y/y increase in NPL ratio to 16.4%. Delayed payments by the government and counties continue to impact negatively on the banking industry's asset quality as well as the tough economic environment of 2017 brought about by drought and the protracted electioneering period.

A more lenient implementation of IFRS 9 on the cards?: Lack of a definitive word on the implementation of IFRS 9, set to commence in 2018 has brought about confusion. The CBK, in a letter to the banks dated 23rd December 2017, drafted a proposal that while the P&L would carry impairment charges as determined by IFRS 9's Expected credit loss (ECL) model, for purposes of 'protecting' an industry already afflicted by interest rate caps, the incremental difference (between IFRS 39 and IFRS 9) would be added back to retained earnings to spare the banks from the expected hit on capital. This was a proposal with the banks expected to provide feedback. At the same time, ICPAK the local auditors' body, tasked by the CBK has proposed that the hit on capital be staggered over five years. Such a lenient implementation of IFRS 9 as proposed by both the CBK and ICPAK will bode well for the banks. International banks Barclays Bank, StanChart and Stanbic are however likely to implement IFRS 9 to the letter, given their numbers have to be consolidated at parent level.

We maintain SELL at TP of KES 33.97 (Previous TP of KES 31.41)

The recent speculation on a possible repeal/amendment to the rate cap law has seen banking counters rally with KCB gaining 15% YTD. At this point it is just speculation with no decisive steps taken or discussed. Our model assumes status quo therefore. Additionally, we continue to assume the implementation of IFRS 9 according to the letter until other-wise declared. KCB has guided at a CoR of 1.3% in FY18F, incredulously lower than the 1.5% recorded in FY17A. If normal loans were already being provided for as KCB intimate, then the chasm between IFRS 39 (specific provisions) and CBK (specific +general provisions) coverage ratios wouldn't be that wide. Also, KCB's statutory loan loss reserves wouldn't be the highest in the industry at KES 11bn. We therefore maintain a CoR of 1.8-2% for FY18F and an improvement in RoAE to 22% from 19.5% reported in FY17A.

Equity Group: SELL at TP of KES 37.10, Current Price KES 47.25

EQB bucked the trend of PBT declines by posting an 8% increase in FY17 PBT to KES 26.9bn. PAT rose by a larger quantum, up 14% to KES 18.9bn on a lower effective tax rate. The growth was unexpected given the 9M17 and 1H17 PBT declines of 4% and 7% respectively. The sudden reversal is ascribed to a halving in impairment charges and an acceleration in non-funded income. NII performance was poor as anticipated relative to peers KCB and COOP, reporting the largest dip at 10%. DPS was left flat at KES 2.00.

NII suffers on decision not to lend: As intimated in our sector update note 'UP AGAINST IT' dated October 10th 2017, and as confirmed by the FY numbers, not lending (in main market Kenya) led to EQB reporting the largest decline in NII of 10% when compared to KCB (+3%) and COOP (-5%) who grew their loans at 10% and 7% respectively. In fact, the evidence is laid bare when contrasting the group and EBKL performance where EBKL re-ports a 16% decline in NII on flat loan growth compared to the group's on a loan growth of 5%. EQB did however make an effort at managing funding costs, managing to decelerate the growth to 2% (1H17; +8%, 9M17; +10%) on customer deposits growth of 10%, but still underperformed in this area when compared to peers KCB (FY17; -6%) and COOP (FY17A; -7%).

Asset quality makes a sudden about turn: EQB's gross NPLs, which had increased by 25% y/y as at 9M17, suddenly improved, declining by 4% y/y and 13% q/q to KES 17.8bn at FY. Asset quality had been on a downward spiral, deteriorating from 3.3% in FY15A, to 7.4% as at 9M17 before improving to 6.3% as at FY17A. In this period, the CoR peaked at 2.5% in FY16A, but this has now halved to 1.26%, following the 50% decline in FY17A's impairment charge. Amongst the cadres, large enterprises have seesawed quite a bit, from nil NPLs in FY16A, to 6% as at 1H17A to nil again as at FY17A. It is worth noting that EQB is the only bank (amongst all listed banks) to report a decline in gross NPLs in a year where the industry NPL ratio deteriorated by 150bps y/y to 10.6% as at December 2017. The achievement is remarkable given the challenging economic environment experienced in 2017.

NIR growth continues to impresses: EQB continues to impress in its efforts at diversifying revenues. As highlighted in our sector update note, EQB has consistently outperformed the sector when it comes to reduced dependence on funded income. It achieved a NIR/ Revenue ratio of 42%, an improvement from 35% in FY16A while both KCB and COOP managed an NIR/Rev ratio of 32%. EQB's FY17A figure is however embellished by the underperformance in NII under the rate caps as discussed above. Mobile banking commissions continue to spur NIR growth, growing by 64% as provision of banking services continues to shift to alternate channels. Equitel and EazyApp are the mobile conduits driving this growth with the former additionally offering telco services.

We maintain SELL at TP of KES 37.21 (Previous TP of KES 34.59)

The recent speculation on a possible repeal/amendment to the rate cap law has seen banking counters rally with EQB gaining 33% YTD. At present, no road map or discussions have been held on the fate of the caps so we leave our model unchanged. EQB remain adamant they will not lend to customers in Kenya until the caps are repealed or amended. As regards IFRS 9, an 0.8-1.2% CoR guidance has been given for 2018, an under guidance in our view, given that provisions for normal/performing loans pre-IFRS 9 were minimal at best. Given that they will now carry 12 month expected losses, one would expect a y/y increase in CoR, not a decline. EQB trades at a rich 2.1x trailing P/B for an RoAE of 21.6%.

Kenya Power (Unrated:): Current Price: KES 6.50.

- Kenya Power posted a significant drop in its 1H18 profit before tax (-19% y/y to KES 10.912bn) mainly attributable to an increase in transmission and distribution costs (+1.6% to KES 33.4bn). Total income strongly gained (+11.4% y/y to KES 120.7bn) on the back of an expansion in electricity sales (KES 87.1bn from KES 92.0bn). The increase in electricity sales was driven by domestic consumers (+13.1%) with the street lighting (+43.2%) revenue also contributing strongly to the topline growth. Total power purchase costs however declined marginally to KES 50.5bn (-KES 784m) on the back of reduced non-fuel costs.
- Total operating expenses similarly rose (+12.7% to KES 118.006bn) driven by an increase in network management (+KES 1.7bn to 11.2bn), commercial services (+KES 0.4bn to KES 4.7bn), administration costs (+KES 2.8bn to KES 17.5bn). We do believe that the operating expenses will keep on increasing steadily owing to the company's focus on achieving universal access by FY20F.
- Going forward, Kenya Power aims to implement the Last Mile Connectivity Project aimed at achieving universal electricity access by FY20E at the same time enhancing the efficiency of the power transmission and distribution networks. We do believe the move to enhance the connectivity rate (among retail and commercial clientele) is likely to boost top-line growth and thus should catalyze profit momentum going forward. We also are very constructive about the positive effects of measures aimed at reducing power losses on the grid.
- We note that over the past few years, Kenya Power has been heavily discounted as evidenced by its very low trailing P/E ratio (1.75x). We believe that the current entry level is attractive for the any investor owing to the fact that the valuation is unjustified.